

**Testimony of**  
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**President**  
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**Hearing on**  
**“Competition in the Sports Programming Marketplace”**  
**Before the**  
**Committee on Energy and Commerce**  
**Subcommittee on Telecommunications and the Internet**  
**United States House of Representatives**  
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Thank you, Mr. Chairman, for your invitation to testify here today on these important issues. My name is Ken Ferree and I currently am President of The Progress & Freedom Foundation, a think tank here in Washington that studies the digital revolution and its implications for media, communications, and technology policy. Prior to joining PFF, I was a private practice communications attorney, briefly served as the chief operating officer and interim President of the Corporation for Public Broadcasting, and, most pertinently, was the Chief of the FCC’s Media Bureau under Chairman Powell. In that role, I lead the staff review of the acquisition of DIRECTV by News Corporation, and was therefore at least in part responsible for the imposition of the mandatory arbitration provisions in the Order authorizing that transaction that have since been invoked in several other sports programming dispute.

## **Market Failure, or Failing the Market?**

Indeed, the mandatory arbitration provisions in the FCC's conditional grant of authority for the News-Hughes merger have proven to be so popular with disgruntled programmers that it is a natural place to begin my testimony. Contrary to what sometimes is suggested, the FCC did not find in the News-Hughes proceeding that the sports programming market generally is failing. Rather, in most cases, the sports programming market functions quite efficiently, ensuring widespread carriage of sports programming services, on multiple platforms, to consumers at reasonable rates. The specific set of circumstances surrounding the proposed acquisition of DIRECTV, a program distributor, by News Corporation, which had interests in a number of regional sports networks ("RSNs"), defined an exception that, we felt, warranted government intervention in the form of mandatory arbitration provisions.

Allow me to emphasize that this was very much of a departure for the FCC. Although the Commission has long enforced a set of statutorily-defined program access rules, which forbid exclusive agreements and certain other discriminatory practices involving satellite-delivered, vertically-integrated programming, the government generally has not otherwise injected itself into contract negotiations between programming suppliers and cable or DBS service providers.

The discretion the government has shown has been a proven success. In the past ten years, the number of cable programming networks has grown from 145 to 565, while vertical integration has decreased (in 1996, nearly 50% of networks were vertically integrated, today less than 15% are). Simultaneously, competition in programming distribution has become a reality (DIRECTV and EchoStar are now the second and third largest distributors of video programming), and large communications companies like AT&T and Verizon have recently entered the video market in earnest.

Having said that, the programming market, like any other, can fail under certain circumstances. In the News-Hughes decision, the Commission found, following an exhaustive examination of the effects of foreclosure by programmers (the withholding of programming from one or more distribution platforms), that although permanent foreclosure was not likely to be a profitable strategy for a vertically integrated News Corporation, temporary foreclosure of access to its RSNs could be profitable, allowing it to drive subscribers from rival distributors to DIRECTV. That is, losses that News Corporation might suffer during the withholding period could be more than offset by gains in DIRECTV subscriber fees.

There were important analytical bases for that conclusion. First, the FCC found that the temporary foreclosure strategy would work only for programming services with the most high-value content. Based on data from prior cases, the Commission concluded that, for the vast majority of program services, subscribers simply will not suffer the transactions costs associated with changing distribution platforms when faced with the loss of a single programming service. Thus, losses incurred by a programmer that withholds its content from a distributor are normally unlikely to be recouped in any economic time frame (and of course, if the content is withheld permanently, losses will never be recouped).

RSNs, on the other hand, are (in the words of the FCC) "comprised of assets of fixed or finite supply - exclusive rights to local...sports teams and events - for which there are no acceptable readily available substitutes." Sports programming also may be differentiated from general entertainment programming in that it is extremely time-sensitive. There is no substitute for a playoff game on the day it is contested. As a result, owners of that content wield a significant amount of market power. When regional sports programming is withheld from a particular distributor, substantial subscriber defections to competing platforms may be expected.

Second, and importantly, for a temporary foreclosure strategy to be effective, the programmer must be able to reap the benefit of any subscriber defections that it can motivate. That is, the programmer must be vertically integrated with the competing distribution platform to which disaffected subscribers will flee.

It is fair to argue whether these conditions were met satisfactory to warrant imposition of a mandatory arbitration provision in the News-Hughes case. Whatever the merits of that initial decision, however, it at least cannot be gainsaid that the merged entity would have ultimate control both of extremely high-value sports programming and a distribution platform in the markets in which the programming was most highly prized. Recent efforts to extend the remedy adopted in that order cannot be sustained on that ground.

For example, last year, in an order approving asset transfers to Comcast and Time Warner as a result of the Adelphia bankruptcy, the FCC imposed mandatory arbitration to resolve an impasse between the cable operators and the Mid-Atlantic Sports Network ("MASN"), a non-vertically integrated RSN that owned the rights to, among other things, the Washington Nationals and Baltimore Orioles baseball games. Oddly, although the News-DIRECTV merger order was cited by the Commission as precedent for its decision, there was almost no similarity between the potential harms sought to be averted in the first case and the actual breakdown of market negotiations in the second.

Most obviously, the MASN case involved no foreclosure by a programmer - the potential harm sought to be remedied in the News-Hughes case. Instead, it was alleged, the distributors in the MASN case were engaging in what effectively became a lock-out. Indeed, because MASN owns no distribution facilities in the relevant region, there is no chance that it could have used temporary foreclosure to affect the downstream distribution market in its favor. Yet, we know

from the FCC's findings in the News-Hughes case that RSN programming is highly valued by subscribers and that the failure to carry the programming will lead to subscriber defections. The only conclusion that can be drawn is not that there was a market failure or that there were anticompetitive forces at work, but that one party to the negotiations (the programmer in this case) simply was overreaching and demanding more than the programming was worth in the market.

The FCC, to its credit, recognized that the rationale for imposing the arbitration condition in News-Hughes was inapposite in the MASN case and stretched to articulate a new rationale by turning the old one on its head. The theory posited in the MASN Order was that, although the distributors would suffer considerable harm in the short term by locking out an unaffiliated RSN, they might do so in the hope that they someday could force the RSN out of the market, acquire the rights to carry the teams involved for their own vertically-integrated services, and then recoup earlier losses with rents from the new vertically-integrated services.

Without belaboring the point, there are reasons to question the plausibility of this potential scenario, not the least of which is that it is completely lacking in any analytical foundation. Yet even this dubious rationale seems now to have been cast aside, as the NFL Network and others have asked for arbitration simply on the basis that a cable operator has not agree to a programmer's demands. For example, as the NFL season neared its climactic final weeks this year, there was concern among policy-makers and fans alike that a subset of the games would not be readily accessible for some because the NFL Network had exclusive rights to those games and it had not reached agreement with several large cable operators for widespread distribution. Whatever the nature of the disagreement between the cable operators

and the NFL Network, it was clear that the dispute did not involve facts analogous to those either in the seminal News-Hughes case, or the mutated step-child MASN case.

The NFL Network is not vertically integrated with any multichannel distribution platform and its programming is not of such regional interest as to render it vulnerable to a lock-out scenario such as that posited in the MASN Order. The NFL Network, to be sure, owns the rights to extremely valuable content. The cost, then, to distributors who do not carry the network must be thought to be substantial. Indeed, because the network is carried on at least one national distribution platform (i.e., DIRECTV), disgruntled consumers have the option of changing service providers rather than miss their favorite teams or important games. But because the NFL Network lacks vertical integration, the circumstances are not like those in News-Hughes where one might fear that the NFL Network was engaged in temporary foreclosure in order to benefit its down stream properties.

Moreover, unlike the MASN case, it cannot plausibly be argued that cable operators which do not come to terms with the NFL Network are trying to lock them out in an effort to drive the NFL Network from the market and obtain access to the carriage rights for their own networks. There is no evidence to suggest that the network's lack of carriage on the cable systems in question poses any threat to its existence or, if it did fail, that the cable operators would have any realistic chance of obtaining the rights to the underlying content.

That is, once again, the natural and logical conclusion from the facts presented is not that there is a market failure requiring government intervention, but rather that the NFL Network simply was insisting upon rates and terms that the market would not accommodate. It is fair to be sympathetic to the fans who subscribe to cable systems that have not acceded to the NFL

Network's demands, but that sympathy is not a basis for regulatory intrusion into negotiations between large, commercially sophisticated enterprises.

To the contrary, the cable operators' refusal to accept the demands of the NFL Network suggests that the market is working efficiently, not that it has failed. The cable industry in particular has been struggling to control consumer prices in the face of increasing costs for programming and expanded services. By holding the line on new programming costs - particularly programming such as that on the NFL Network which appeals to a defined subset of consumers - the cable operators may be able to help control against cable rate increases for all subscribers.

In short, there are powerful forces acting on both sides of the bargaining equation. On the one hand, sports programming networks own extremely valuable content, which, generally speaking, distributors wish to carry. On the other hand, program distributors are under tremendous pressure to control consumer rates; limiting programming costs is perhaps the most direct means of achieving that end. The market, not regulatory authorities or appointed arbitrators, is best positioned to balance those interests.

This analysis also helps inform the debate surrounding two other issues that arise in disputes over the carriage of sports programming: whether distributors should be prohibited from carrying sports programming on a special tier, and whether the government should require programmers and/or distributors to offer services on an “a la carte” basis. Both queries should be answered in the negative.

## **Tears for Sports Programmers, or Tiers for Sports Programmers?**

Sophisticated entities sit on both sides of the negotiating table when sports programming services and program distributors bargain over carriage. Large program distributors obviously have a measure of leverage by virtue of their access to the end-user viewers. On the other hand, sports programming services control uniquely popular programming assets for which there are no close substitutes. It is unsurprising, therefore, that market negotiations between the two can be intense, confrontational, and that they sometimes involve a degree of brinksmanship. That is not saying, however, that the market has failed or that government intervention in these negotiations would be necessary or appropriate.

As noted above, program distributors are under intense pressure to contain subscriber rates. One means of controlling base rates that all subscribers pay is to segregate niche programming services to special tiers, which allows the distributor to pass the costs of carrying the programming on to only those who most value it. Niche sports programming services, such as the NFL Network, are particularly amenable to special tier placement because their most popular content is seasonal, it appeals to a well-defined subset of the entire subscriber base, and it is expensive to produce and, therefore, distribute. In those circumstances, it may well be more economical to require those fans that highly value the content to bear the cost of its creation and distribution rather than requiring all subscribers to shoulder that burden.

Naturally, that conclusion does not sit well with content owners, which would prefer that their services be carried on the basic tier. Basic tier carriage provides a much larger potential base of viewers and it allows the cost of producing and distributing the content to be subsidized by subscribers who would otherwise not be willing to pay separately for the programming. One can well understand bare-knuckled bargaining by sports programming services in an effort to

force basic tier carriage. Too often now, though, when such bargaining fails and they cannot achieve their sought-after ends in private negotiations, programmers raise importunate pleas to Congress and the FCC for help. Those pleas should find no sympathetic ear.

Government intervention in programming disputes may be appropriate where one party or another will benefit from a breakdown of market negotiations. In those cases, a plausible argument can be made that the market is prone to fail and that consumers will suffer as a result. In the disputes over tier placement that we have seen to date, however, there is little evidence that any of the parties involved will reap any kind of advantage from a bargaining impasse.

To the contrary, the negotiations in these cases involve the balancing of competing interests in providing compelling programming to subscribers, controlling basic tier costs, managing system capacity, and remaining profitable going-concerns. And because so much is at stake both for the content owners and the distributors, there is tremendous pressure on both parties to complete negotiations. Although neither party may be entirely satisfied with the result, that is the nature of free market negotiations. Government intervention to prohibit or limit the use of special sports programming tiers can only serve to mute market signals and drive the process to a less efficient outcome.

### **Prix Fixe or A La Carte?**

Similarly, just as government intervention into the sports programming markets to prohibit or limit the use of sports tiers would be unnecessary and potentially counter-productive, mandated “a la carte” pricing at the wholesale or retail level would likely decrease programming diversity, increase vertical integration in the programming and distribution markets, and increase consumer costs.

For the majority of programming services, the incremental cost of programming and/or the widespread, year-round appeal of the programming content make retail bundling an attractive, efficient, economical, and consumer-friendly means of distribution. Bundling can lower transactions costs, allow programmers to achieve economies of scale, enhance consumer convenience and, perhaps most importantly, allow for appropriate pricing differentiation. In effect, bundling allows each of us to enjoy our favorite programming whether or not it can alone attract large audiences.

This model breaks down, however, when a niche programming service is both of limited appeal and expensive to produce and distribute. This, of course, describes many RSNs and other specialized sports programming services. In those cases, as explained above, it likely will benefit consumers to allow distributors to carry the programming service on a special tier. For other types of programming, though, including general entertainment programming, consumers likely benefit from bundled offerings.

Similarly, bundling at the wholesale level can facilitate the realization of scale economies and lower transactions costs, both of which, at least potentially, can redound to the benefit of consumers. Further, as the FCC found when it studied this issue in 2004, some wholesale bundling is a function of the statutory retransmission consent process, which appears to be working as Congress intended to facilitate the introduction of new programming services and allow for non-cash compensation for the carriage of broadcast outlets. Of course, to the extent other forms of wholesale bundling or tying arrangements are being used for anticompetitive purposes, antitrust remedies remain available.

## **Conclusion**

Although disputes involving sports programming often generate emotional consumer responses, the fact is that the sports programming markets generally are competitive and fully-functioning. Negotiations surrounding sports programming carriage involve hard bargaining by sophisticated parties over complex sets of interests. The terms of any such carriage are better decided at the bargaining table; government intervention rarely should be necessary.

Thank you.